RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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Nov. 6, DJIA 852.45; PTI 1394; A-D Ratio –22.92
Nov. 13, DJIA 855.88; PTI 1414; A-D Ratio –22.71

**WHAT'S HAPPENING?** What's happening is that the Fed is doing what it said it wouldn't do – and that's panic. The Fed obviously took in the crumbling housing picture, it surveyed the collapsing auto picture, it saw the ominous inventory picture, and it studied the unbelievable financing needs of the Treasury. Then the Fed threw in the sponge – it panicked. First it removed the special discount rate "surcharge" for large banks, then on October 30 it lowered the discount rate. Fed Funds (which were over 20% last June) are now in the 13-14% area, and free reserves in the banking system are heading towards the plus side.

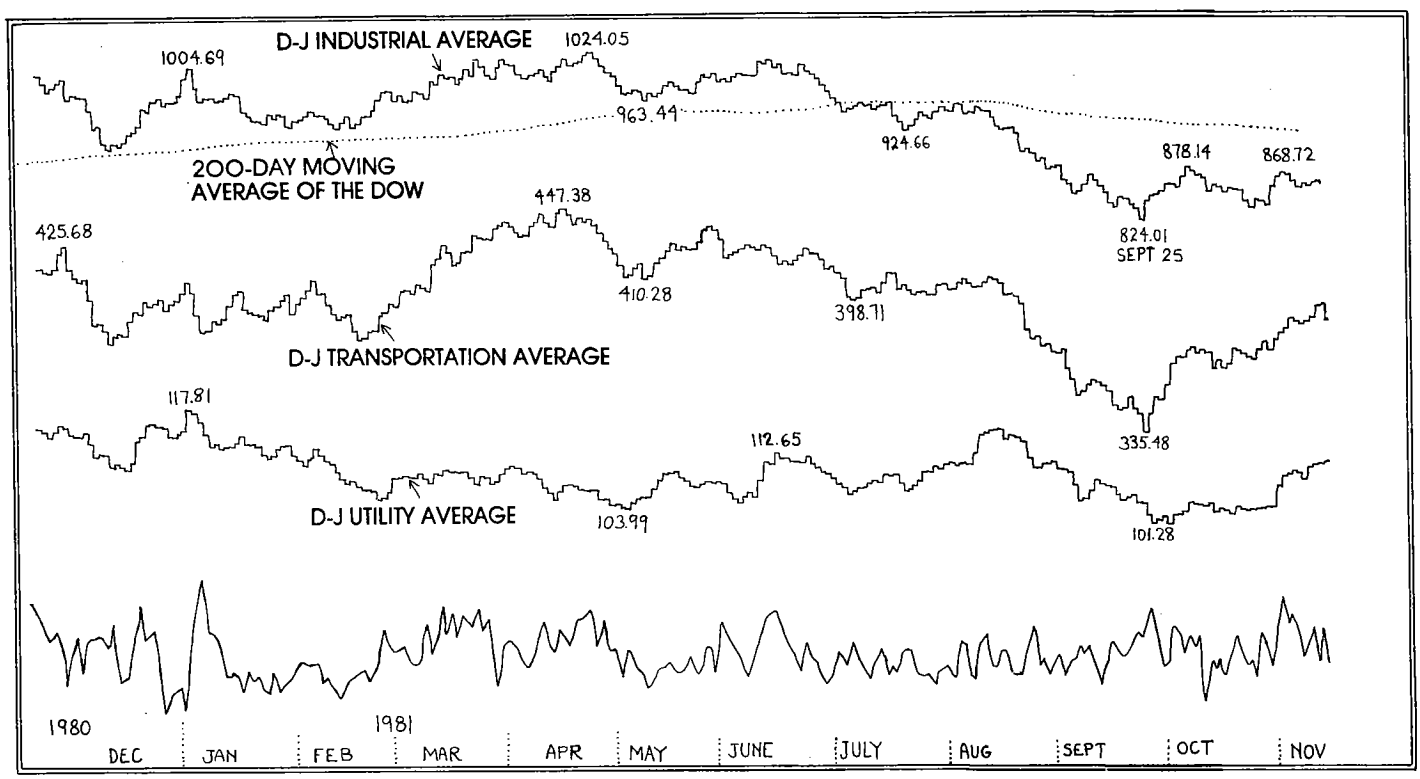
The remarkable thing is that with all this Fed action, the precious metals (and commodities) are weak. Are the forces of deflation and sliding business stronger than the Fed pumps? So far, that seems to be what the markets are saying.

Fed action has had a dramatic effect on the money market where bonds and money instruments have taken off on a violent (in my opinion) bear market rally. The accompanying decline in interest rates has sent the stock market into a further bear market rally of its own. My advice – beware . . . . bear rallies tend to end as abruptly as they began.

**PRICE MOVEMENT: LONGER TERM:** On February 28, 1978 the Dow recorded a low of 742.12. That was the lowest reaction low since the 1974 bottom. Following the 742.12 low, the Dow climbed irregularly to a high of 1024.05 on April 27, 1981. The rise from the 742.12 low to the 1024.05 high was 281.93 points.

**FRONT PAGE COMMENT:** Here are a few opinions that I want to put on the front page of this Letter. (1) Despite widespread talk of a "quick, sharp" recession, I expect this recession to be drawn out and painful. I also expect a major decline in corporate profits. (2) I believe one of the shockers for next year will be the size of the fall-off in Government tax receipts. It's going to be huge. (3) Another shocker I am predicting is that the drop in interest rates is NOT going to help the building industry or business in general. People are becoming frightened, and the current inclination is to save. (4) The consensus among analysts is that recession and accompanying interest rates will be good for stocks. That's true during a bull market correction such as 1957 or 1962, but I predict it will not work this time. This bear market contraction in the economy will not be good for stocks.

THINGS TO COME? Two years ago GM had working capital (current assets minus current liabilities) of $7.5 billion. A year ago their working capital had dropped to $4 billion. It is now down to $367 million! In third quarter 1981 GM lost $468 million – yet the company paid a 60 cents regular quarterly dividend. That single dividend cost GM about $180 million or (incredibly) about half GM's working capital! The third quarter loss of $468 million equalled 2½ times the GM dividend. What was GM thinking? Obviously, GM was trying to hold the price of its stock up, and it was gambling that there would be a 1982 upturn in car sales. My prognosis: unbelievable stupidity and misplaced optimism. Look for wholesale dividend cuts in many industries in 1982.



Under the 50% principle which I have written about over the past 20 years, it is important to see what the Averages do at the 50% level following an EXTENDED movement.

The rise from Dow 742.12 to 1024.05 over three years certainly qualifies as an extended movement. The halfway point of that three-year rise was 883.08. On August 31, 1981 the Dow closed below 883.08, and the Average continued down. On September 5 the Dow closed at 824.01 – decisively below the halfway point of the 1978-81 rise.

According to the 50% principle, it would be normal (expected) for the Dow (since it could not retain 50% of its 1978-81 gains) to eventually approach or even violate its 1978 low of 742.12. There is no time frame for the expected approach to the 742.12 low, but my guess is that it could occur before or during first quarter 1982.

INTERMEDIATE TERM: Following the September 25 lows (see page 1 chart), the Industrials rallied to an October 8 high of 878.14, Transports to 373.07. The Averages then backed off tc late-October lows, whereupon a new advance began. On the second rally Transports rose to a new recovery high (above 373.07) but Industrials halted (October 3) at 868.72, 10 points under their preceding high. Thus, we have a non-confirmation, and unless Industrials can push above 878.14 this could mark the beginning of the end for the rally since September 25.

It is important to remember that under Dow Theory only movements confirmed by BOTH Averages are considered valid. That means that for a valid (confirmed) move on the upside Industrials must better their October 8 high of 878.14. On the downside a valid break would entail Industrials breaking below 824.01 confirmed along with a Transport violation of 335.48.

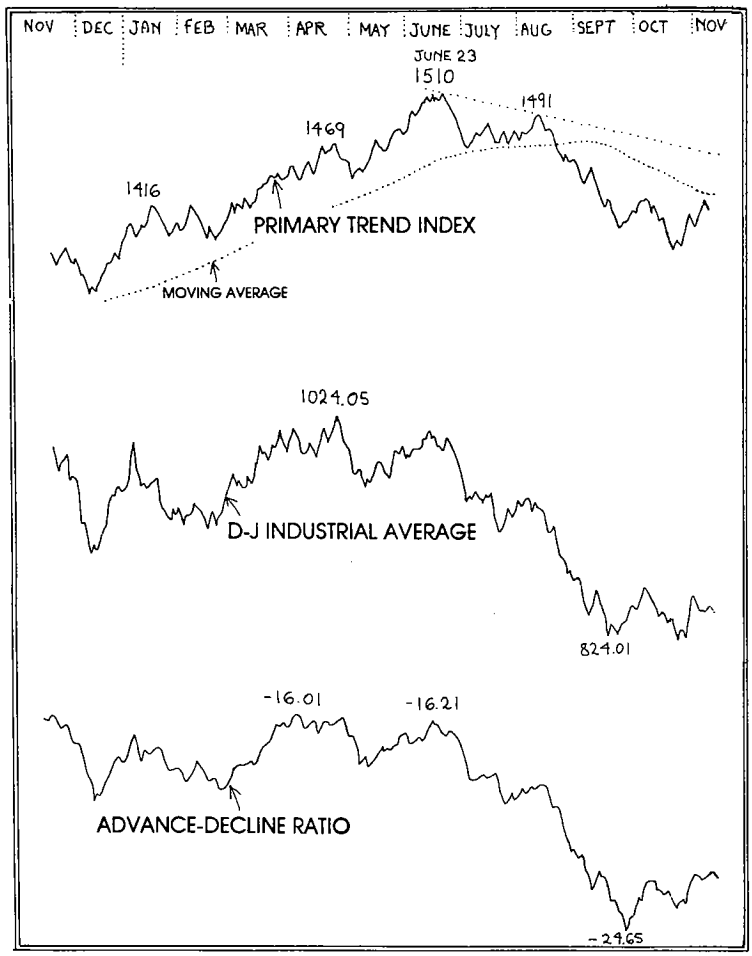
The Transports have been notably strong over the past month, and if the market was to suddenly swoon, it appears to me doubtful whether the Transports would confirm on the downside. This could lead to a frustrating stand-off, a locked-in trading range for stocks. Well, the stock market never promised us fun and games at all times, and it's even been whispered that many serious investors like stability.

* *

The Primary Trend Index (PTI) is my own proprietary market index, and as veteran subscribers know, this index has been of considerable help to us in gauging the trend of the market. I operate on the basis that a continuing downward trend in the PTI will put downward pressure on the market, while the converse is true during a rising PTI trend. Which means that what we have to do is correctly analyze the trend of the PTI.

As of now, the PTI is holding well below its major declining trendline, a trendline that is drawn through the June 23 and July 13 peaks. The low for the PTI was struck on October 26 at 1374. Since then the PTI has rallied to a November 12 high of 1420. This puts the PTI practically in contact with its 21-day moving average, as you can see on the chart.

I am not one to argue with my own PTI – it's record has been too good. If the PTI moves up above its 21-day moving average, it will be a definite confirmation of a secondary bullish trend. From there the question is whether the PTI has the power to push above the major declining trendline. If that occurs the PTI will be technically in position to make an assault on the June 23 high of 1510. But that's jumping ahead of the story, and for now




I'd prefer to simply watch the PTI and let it provide its technical message.

The A-D ratio at the bottom of the chart is a proxy for ALL the stocks on the NYSE. The A-D ratio has traced out a little upward zig-zag, and I attribute the strength in the A-D to the rise in the interest rate-sensitive stocks on the NYSE. However, despite the help of declining interest rates the rally in the A-D ratio is far from impressive.

Following what appears to be a significant low point, many analysts watch for so-called "breadth signals" before turning bullish. One such system states that an advance is not valid unless the market generates three consecutive days in which there are 1000 or more advances. Another breadth system states that there must be one day in which both volume and points of advance are on a ratio of 9 to 1 in favor of the upside. Neither of these breadth signals have occurred on the rally from the September 25 lows. Breadth, as a matter of fact, has been sub-standard on the rally.

**OPPOSING OPINIONS:** It is rare to see so many leading and intelligent analysts disagree so completely and so violently on the market. For instance, on Nov. 6 Marty Zweig put out a report entitled "Super bullish," and Marty now recommends 100% investment in common stocks (for only the third time in 10 years). Ned Davis is bullish, Perry Wysong is bullish as is Gil Haller, Yale Hirsch, Larry Williams. On the bear side Joe Granville's latest report states that the market is about to go "over the precipice." He thinks (as I do) that we have been seeing a rally

in a bear market. Other bears include Ian Mc Avity, Bert Dohman-Ramirez, Stan Weinstein, Bill Bretz.

Quote of the week: *"The Market Logic Sentiment Index continues to soar, rising this week to 59% from 47% two weeks ago. It is now nearly double the 32% bullish reading of five weeks ago. Never before have so many market letter writers correctly identified a major bull move so soon after it started . . . . assuming this is a major bull move."* (from *Market Logic,* 3471 N. Fed H'way, Ft. Lauderdale, FL 33306).

**IMPORTANT:** I continue to believe that we are in a longer term primary bear market, but I also feel that we are at a particularly tricky juncture. The first phase of the bear market is now ended (it ended on September 25). The bear's job now is to convince as many investors as possible that "the worst is over" and that "everything's all right." This will require all kinds of false signals and deceptions but the bear has a bag full of such tricks.

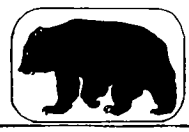
One of the purposes of technical analysis and in fact, of all market systems, is to take the guesses, the feelings and the intuitions out of investing. I've always felt, however, that the strongest thing I possess is an intuition about the market. I don't know exactly where intuition comes from, and I don't know exactly what it is or how it works. But I know it's there. And my intuition says that a steady, conservative course is going to save us a lot of heart aches and money losses in the period ahead. My intuition also tells me that we're moving into a very deceptive period for stock investors. I don't like what I see ahead.

As an aside, I have been (as usual) speaking to traders and investors from all parts of the country, and I don't think I have ever heard so much about "bad trades" and "whopping losses." Commodity traders, many of them, have taken terrific beatings over the past year. It may just be that stock traders are next on the list.

This market has been in a trading range for months, and trading ranges are conducive to just that – trading. Some individuals make money trading the market, but many more lose their shirts at this most difficult of procedures. Remember this: when you make a profit in stock trading, you pay taxes on that profit. When you lose money on a trade you are losing after-tax dollars that may actually cost you two dollars for every dollar you lose. So mathematics militates against the trader, because profits are only part-profits and losses are often double the actual listed loss. For every trader that gets rich, there are ten that lose their money and ultimately turn to other games.

**INVESTMENT POLICY:** I've been combing through the performances of a large number of no-load funds. In the "Maximum capital gains" category the *leader* (Nicholas) appreciated 10.6% over the last year, but dropped 3.7% over the last 6 months. In the "income fund" category, the *leader* (Vanguard's Quality Div. Port. 1) rose 7.5% over the last year, declined 0.9% over the last 6 months. The fact is that the large majority of funds did not do well over the past year; certainly the investor in T-bills did better.

I feel the storm is still overhead, even though a few clouds have temporarily parted. I don't think a policy of trading secondary corrections in bear markets works for most people. Therefore, my advice is to stay with the T-bills. We've got an illiquid economy that is sliding into recession. Ultimately, that's a recipe for trouble.



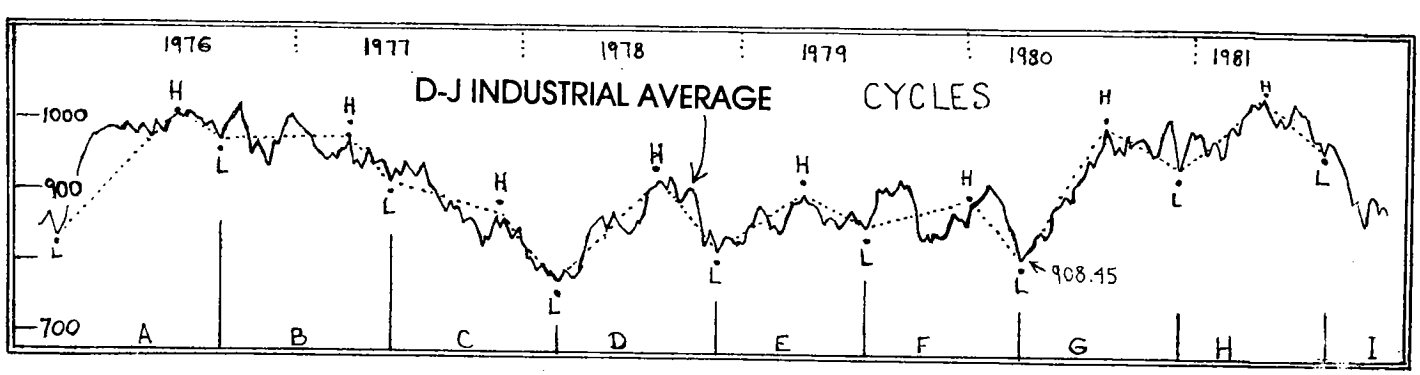
**233 DAY CYCLE:** I have identified a 233-day cycle (chart below) in the stock market, a cycle that has been in force for many years. Each completed unit of the 233-day cycle is made up of two segments. There is a bull segment which lasts approximately 144 days and a bear segment which lasts about 89 days.

The operation of cycles in the stock market is comparable to breathing in a living organism. There is the inhalation which I liken to the bull segment of the cycle. And there is the exhalation which is comparable to the bear segment. Thus, nature and the markets are very similar.

Referring to the accompanying chart, note that the bull segment of the H cycle ended at the April high of the Dow at 1024.05. The bear segment of the H cycle then took over, and this segment carried down to the July low of Dow 924.66.

Next, the bull segment of new cycle I began. But here the market was so weak that the bullish cyclical influence was thrust aside. Despite the bull cycle, the Dow plunged to a September 25 low of 824.01. The market is currently still in the bull segment of the cycle, and I calculate the bullish influence to remain in force until around the middle of December (give or take a few weeks).

Studying the chart, note that the last time a bull segment of a cycle was this weak was during the C cycle back in 1977. It is



very rare for the market to be lower during the length of a bull segment of any cycle.

Conclusion: If the Dow is below 924.66 (the point where this bull segment began) by mid or late December, we will have cyclical indications of a very weak market. Then (as the bear segment of the I cycle begins) I would expect a new plunge to new lows, probably as the first quarter of 1982 gets underway.

**HIGH FINANCE:** The Office of Management and Budget confirmed two weeks ago that their "worst case" estimate shows a budget deficit of $98 billion in the current fiscal year, $125 billion (deficit) in 1983 and $145 billion (deficit) in 1984. This adds up to a three year deficit of $368 billion. Despite the White House's characterization of these estimates as "patently unrealistic," we know that one can NEVER dismiss a worst case scenario when it comes to US Government budgets.

On November 6 it was announced that the US unemployment rate had jumped to 8%. With auto and housing sales collapsing, with retail sales sluggish, with unemployment at recession levels, it is doubtful whether, in the period ahead, (1) there are going to be any significant tax increases, or whether (2) there are going to be any major budget cuts.

Assuming that to be true, how can the US possibly finance one-third of a trillion dollars in deficits over the next three years? The answer is clear; they will sell some of it to the public via bills, notes and bonds. And they'll let the Fed buy some of it, which means monetization of the debt and more inflation of the money supply.

How would a third of a trillion dollars in new deficits affect stocks over the next few years? Since this amount of new deficit financing would almost surely drive interest rates higher, we would expect the coming deficits to be basically bearish for stocks. Nevertheless, it will pay us to keep an open mind on the whole process, and the best way to keep our minds open is through the process of following the markets.

Note: Sadly, I must report that one third of a trillion in deficits over the next three years could prove to be a very conservative estimate. The way things are going, I expect a three year deficit (including off-budget expenditures) of over $400 billion. And the current recession will only make matters worse (the bigger the recession, the greater the tax fall-off to the Government).

Question: Russell, why can't the Government simply make major slashes in the budget, raise revenues via a value added tax or some other series of taxes and cool this crisis before it ever starts?

Answer: This nation is run by politicians, not statesmen (although I think Reagan is trying to be a statesman). But politicians work towards one major goal – getting elected. The way things are going, I don't see today's Democratically controlled House attempting to bail the Republicans out via massive budget cuts and major tax increases.

Furthermore, Reaganomics is just beginning as far as President Reagan is concerned. It's hard for me to envision the President reversing gears and literally jettisoning his whole economic program by raising taxes over the foreseeable future. And as far as big budget cuts, with a Congressional election coming up in 1982 I just don't see the cuts coming.

Question: OK, Russell, then how do you see this whole impasse working out?

Answer: I'm sorry to say it, but I don't see much of anything "working out." What I do see is a Congress that is willing to let the deficits run. The whole thing is like a two mile long freight train that has lost it's engine and is roaring out of control.

Question: Short term interest rates have come down hard over the last month. When that happens commodities (and gold) usually take off on the upside. But they haven't. What does this mean?

Answer: I think it means that the recession is hitting harder and faster than anybody realizes. It could just be that business is now falling apart.

Question: Business is now tumbling, but won't the lower interest rates turn the economy around by 1982?

Answer: Perhaps, but this nation's growth has always been financed via longer term debt. The fact is that long-term rates have not come down that much. Mortgage rates, for instance, have to get down to 12-13% before buyers are interested, and they are far from that now.

A second point is that consumer's don't act like Pavlov's dogs. Consumers don't automatically spend their heads off any time interest rates drop. The major impetus behind consumer buying (and all buying) is confidence. If consumers lose confidence, I don't care where interest rates go, they are going to save rather than buy (in the 1930's interest rates were in the 1-3% area, and people didn't buy–they were frightened and afraid to take on debt).

**NOTES & QUOTES:** Sadly, dissension now rules in the Reagan Administration. Leaders in the Administration differ radically on the military stance, and the fate of the MX and B-1 are being debated anew. The economic position of the Reagan people is also much debated. With the publication in *Atlantic* of the Stockman bombshell, it's anyone's guess as to what happens next. On his November 12 TV appearance a chastised Stockman took back everything he said although he never denied that he said it. My own belief is that Stockman is a good man and probably the only man in Washington who understands the budget (which is one of the reasons that his resignation offer was not accepted). When Stockman saw the politics, trades, compromises and frustrations involved in getting the Reagan program through Congress, he grew disillusioned – hence the *Atlantic* magazine bombshell article.

On November 15 the L.A.Times broke the story that Stockman's authority is to be severely limited. His power to negotiate legislative deals and even his Congressional testimony will be curtailed. With Stockman's fall from grace, Treasury Secretary Regan's

star ascends. My opinion is that Regan is just an Administration mouthpiece, an articulate hack who never should have been given the Treasury job. I'm afraid the Reagan Administration as it now stands, has no economic policy and little inkling as to where we are heading. The Reagan economic ship is starting to leak badly.

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Some few months ago I stated that I have my own barometer of world trouble spots, and it is – where subscribers are going. At the time I noted that many of my subscribers were leaving Costa Rica. Now comes the news that Costa Rica (the "Switzerland of Central America") is unraveling. It can't pay the interest on its foreign loans (even though it has no military). Inflation is going wild in Costa Rica, and unemployment and business bankruptcies are rocketing. This is a tragedy, since Costa Rica has been the sole model for democracy in Central America.

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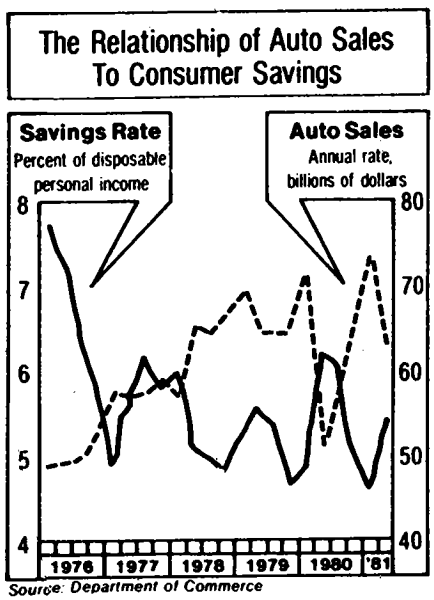


This tell-tale chart shows that the savings rate in the US dropped to a six-year low in early-1981. Historically, the savings rate runs counter to the auto sales rate (when people buy cars, they save less). My own guess is that the savings rate has now bottomed out, and that we are now in for an extended trend in which American consumers attempt to build savings and liquidity. If this is so, we are going to see difficult times over a goodly period of time for auto makers and home builders.

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I received the latest *International Harry Schultz Letter* a week ago, and I was amazed to see that Harry now believes that we face deflation. Harry notes that "*. . . . deflation begins at the moment the rate of increase turns down. But the biggest single factor that turned me bearish on inflation was the synchronized collapse of world stock markets, which (say my charts) will be ongoing and will shrink buying power dramatically.*" Harry isn't sure how long deflation will last, but he notes that "*. . . . a danger lurks that deflationary momentum will be so strong it will carry us into a bone-crunching depression.*"

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Harry is a member of the "old timers club" (Letters started prior to 1965). And so is Joe Granville. Here is a rather dramatic quote from Joe's report of October 24: "*I told a Toronto audience this past week that Ronald Reagan will probably go down in history as the Herbert Hoover of this generation. I have been saying that since January. Now some very respectable sources are suspecting the same thing. Economic forces are calling the tune and those forces are saying that JUST THE OPPOSITE of the Reagan promises will be coming into play. The budget will NOT be balanced, taxes will be RAISED, not lowered; interest rates will RISE, not be lowered; inflation will increase, not decrease, and the bond market and the stock market will decline, not go into a bull market. I wish it weren't so but the handwriting is on the wall: unemployment will rise, there will be a significant increase in corporate bankruptcies, a significant increase in bank failures, a further collapse in the housing industry, a significant rise in the degree of social unrest, increasing strikes, marches on Washington, a decided increase in the suicide rate, a crash in world markets and even the ultimate closing of the stock exchanges. No, I am NOT a doomsayer. Anybody who has followed my record knows how bullish I was on the 1974-76 bull market and the 1978-81 bull market.*"

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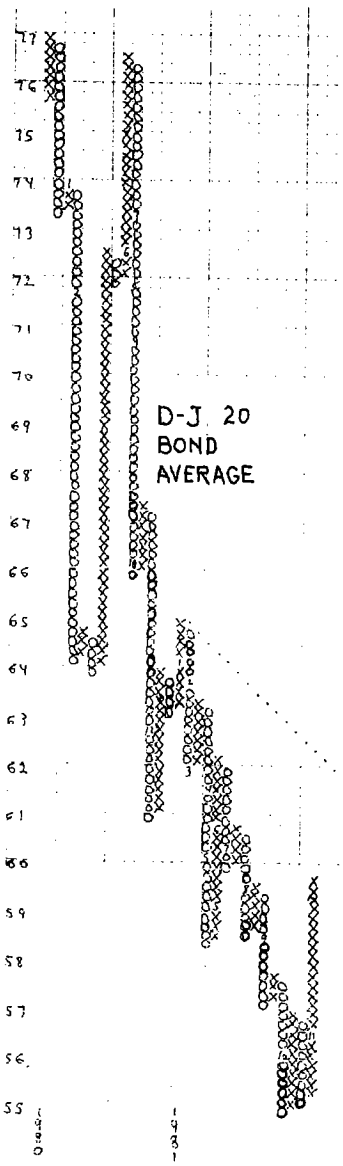


It's a thumping bond rally, fueled by the Fed's new stance of ease, a running of the shorts and high hopes from various sages on Wall Street. My point and figure chart of the D-J 20 Bond Average adds some perspective to the picture. So far, the rally doesn't look too different from any of the other rallies of the past couple of years. Fundamentally, the only change is that the fundamentals look worse. *Market Logic* (Ft. Lauderdale, FL) has been very good on budget estimates, and their latest estimate for fiscal (current) 1982 is a Federal deficit (including off-budget spending) of $125 billion! And all those billions have to be financed, remember.

**Due to scheduling and printing difficulties surrounding the Thanksgiving holiday, our next Letter will be mailed DECEMBER 3rd.**

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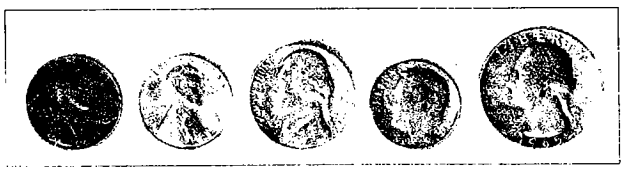
The latest coin to bite the dust is the penny. Cost of the current penny to the Government is eight tenths of a cent. In December a new penny will be issued which is 97.6% zinc (coated with copper). The new penny will cost the Government six tenths of a cent. Item: the demise of every great nation can be tracked via the debasement of its coin and currency (chart of coins courtesy *US News & World Report).*

**Metallic Worth of Coins**



| Current Penny | Future Penny | Nickel | Dime | Quarter |
|---|---|---|---|---|
| 95% copper, 5% zinc VALUE: ½ of 1 cent | 97.6% zinc, 2.4% copper VALUE: ¼ of 1 cent | 75% copper, 25% nickel VALUE: 1.6 cents | 91.7% copper, 8.3% nickel VALUE: ½ of 1 cent | 91.7% copper, 8.3% nickel VALUE: 1.2 cents |

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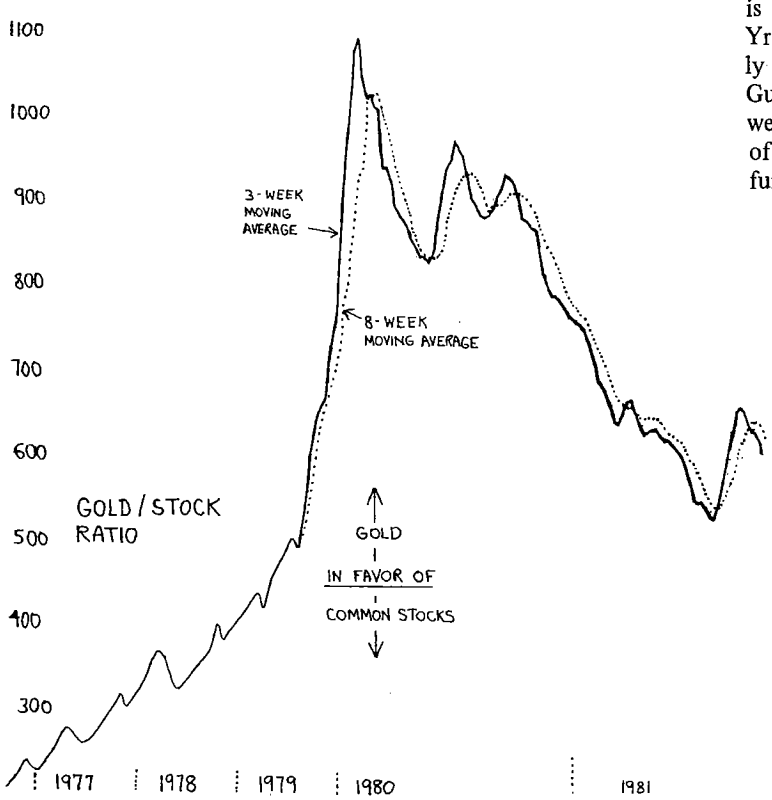
The US population from 1978 to 1980 rose 11%. The populations of all but one of the 11 western states surpassed the average. The top three states were Nevada (up 54%), Wyoming (up 40%), and Colorado (up 30%). Why Nevada, you ask? My guess: Nevada has a very low population, only 800,000. And most important, Nevada has no taxes. Below is a rundown by *Money* magazine showing cost in 14 areas of the nation. Note that the big swing factor (in dollars) is the cost of housing.

| LOCATION | TAXES | TRANSPORTATION | HOUSING | TOTAL |
|---|---|---|---|---|
| SAN FRANCISCO | $3,173 | $6,345 | $35,381 | $44,899 |
| LOS ANGELES | 4,221 | 6,241 | 30,250 | 40,712 |
| NEW YORK CITY | 5,243 | 5,656 | 28,974 | 39,873 |
| DETROIT | 6,596 | 5,370 | 24,671 | 36,637 |
| CHICAGO | 6,362 | 5,785 | 23,699 | 35,846 |
| PHOENIX | 6,086 | 5,019 | 22,292 | 33,397 |
| DENVER | 6,940 | 5,576 | 19,731 | 32,247 |
| SEATTLE | 5,825 | 5,129 | 21,045 | 31,999 |
| SALT LAKE CITY | 7,433 | 4,911 | 19,258 | 31,602 |
| U.S. AVERAGE | 7,046 | 5,012 | 19,498 | 31,556 |
| HOUSTON | 6,369 | 5,552 | 19,528 | 31,449 |
| ATLANTA | 7,437 | 5,079 | 18,840 | 31,356 |
| CASPER, WYO. | 6,467 | 4,715 | 19,629 | 30,811 |
| ALBUQUERQUE | 7,297 | 5,064 | 17,753 | 30,114 |
| HOBBS, N.M. | 8,413 | 4,475 | 14,349 | 27,237 |

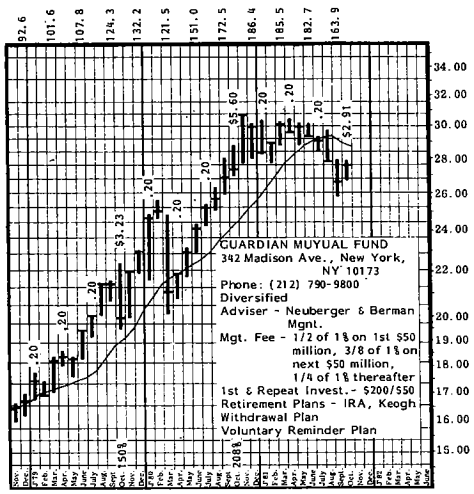
**GOLD:** The chart below shows my ratios of gold and the NYSE Composite Index. The basic daily ratio is arrived at simply by dividing the price of gold by the NYSE Composite. I then construct a 3-week and an 8-week moving average of the ratio. When the 3-week MA (heavy line) breaks below the 8-week MA (dotted line) this is a signal that stocks, as exemplified by the NYSE Composite, are acting better than gold. When the black line breaks above the dotted line, this means that gold is acting better than common stocks.

In general, I would say that it has proved unprofitable to hold gold when the black line is below the dotted line (as now), and profitable to hold gold when the heavy line is above the dotted line.




Gold has been weak over the past few weeks, but despite all kinds of feints and swoons, the metal continues to hold above the 400 mark. Many wonder if the Fed (which is injecting funds into the banking system in an attempt to balloon the economy up again) will set off another round of inflation. We know what the Fed is doing, but we don't know whether it will "take." In the meantime, from the monetary standpoint only, the pendulum has swung in favor of gold. Seldom has gold continued to slide while the Fed was pumping air into the monetary balloon.

**LATE COMMENTS:** I always watch the performance of the leading no-load funds. Many of these funds are aggressive, well-managed and worth owning in any kind of a rising market. One of the best and easiest ways of watching the no-load funds is via the Growth Fund Guide, Growth Fund Res. Building, Yreka, CA 96079. This is one of their charts showing the monthly action of an excellent fund that I have often recommended, Guardian Mutual. As you can see, this fund has now dropped well below its moving average and it is selling at about its price of a year ago. Its action is typical of the better managed no-load funds.




**NEXT MAILING: DEC 3**